TRADE WARS AND RISK OF UNWINDING GLOBALIZATION

Anand Ramachandran/ River Valley Asset Management Partner
Kübra Şebnem Koldemir / Poly Consulting General Manager

Global markets have been volatile for the last few months as they are struggling to price in risk of events which are unfolding. Optimists may state that this is transient and once the dust settles markets will take the new narrative in its stride, price it in and continue on it normal course. To the optimist the current focus on trade wars is nothing new and in 2010, just as the dust from the Global Financial Crisis was settling down, the rhetoric from the Obama administration on need to reform the unbalanced world was at a similar crescendo. But what is different this time is the ever-changing narrative on trade and deficits, as the rules under which the world was operating for a few decades now are being upended by its very creator, the United States of America, under its mercurial president Donald Trump. Markets are good at pricing risk whose outcome can be estimated with some probability but when the end game is not clear, it is a sign that volatility may be here to stay.

Globalization and the changing narrative

Since the end of World War II, the world economies have broadly operated under a set of rules, called the Bretton Woods system with the US acting as the benevolent referee. This has been a period of rising globalization and deepening world trade, which has grown exponentially to account for nearly 60% of world GDP now, from less than 20% then. While the world in aggregate and emerging economies of Asia in particular have benefitted over this period, it has led the perceived losers in Western economies to question the benefits and elect strongmen as leaders who profess to have a solution. This is visible in election results in Southern Europe or the Trump phenomenon or numerous similar examples in other countries. As these new leaders try to deliver on their quick fix promises (instead of reforming deeply entrenched inefficiencies & bottlenecks), it is leading them to question benefits of existing rules which they consider unfair. Markets are struggling to price this kind of probabilistic risk. We saw an example of this in May when three months after the Italian election, a negotiated coalition government staked claim to government and questioned existing arrangements in Euro leading to the European currency and markets freaking out.

Elephant in the room - trade wars

When US president Trump took office in early 2017 markets initially worried about the impact on risk premiums as the president went about questioning the existing order of business. Nearly a year and a half into his term we are now seeing the rhetoric turning into action and neither the market nor seasoned observers can fathom the end result. This increasingly can lead to unexpected outcomes with non-linear risks. The clear worry for the world is the narrative emerging from Washington, i.e., the US administration does not seem to believe in the existing system of global rules and is happy to unilaterally attempt to change them. This is creating exasperation both for age old allies of USA as well as perceived adversaries. President Trump seems to be singularly focused on reducing US trade deficit (quickly) even if it means tearing up existing agreements.

Economies and markets which have prospered and grown during the win-win decades of global trade under the aegis of WTO are struggling to grapple with the new reality of a President who nonchalantly tweets, "Trade wars are good and easy to win". In a zero sum world of Trump where I win if you lose, the risk of a presidential action overnight unraveling years or decades of well laid out business plans, focused on maximizing on comparative advantages of global supply chains, is non-trivial. This is a risk, which markets will struggle to put a price as the end outcome is not certain. In the initial days post Trump election, markets in Asia got roiled before settling higher as investors worried about Trump and trade. Eighteen months on the unlikeliest of countries, the closest allies of US in G7 are getting roiled by Trump's tariff wars. Countries are publicly discussing tit-for-tat tariffs and that is a slippery slope, which unravels years of globalization gains. The problem with high stakes negotiations, which go to the wire with extreme positions is that it is difficult to step back, if needed, and the unintended consequences are difficult to fathom. Markets will struggle to price in the risk from this potential new world of trade tensions. And, Asian economies, which were the biggest beneficiaries of global trade over the last two decades could end up with significant collateral damage.

If we look back, Brexit provides a classic template of how risks impact markets in the new uncertain world. Two years on, nobody knows what Brexit means, leave alone the governments which are seemingly negotiating this. Every few months, the British pound gets roiled by a new narrative, before it settles down realizing that the new information is no different from the existing confusion. Trump's trade wars could potentially end up replicating the same. When none of the parties involved is wiser on the end outcome, every new tactic seem apocalyptic before it dawns on everybody that it is not different from the previous one.

Who has more to lose in trade wars?

Simplistically, when it comes to trade wars, countries with trade surplus will have more to lose economically compared to countries with a trade deficit. For example, the trade dependent Chinese economy ships nearly 20 percent of its exports to the United States. It sold $506 billion in goods and services to the United States last year. In contrast, the United States sold only $130 billion to the Chinese. Therefore, bilaterally China has more at stake in a tariff war with the USA and that is why after the initial $50bn tariff announced by Trump on talk of retaliation by China he upped the game by threatening tariffs on another $200bn of Chinese imports into the US.

The problem for the world is the fact that goods China exports to the USA comes with a lot of imported components, for example Korean and Japanese components which go into the final assembled product shipped to America. These inter-linkages are what leads to the conclusion by some that trade wars are bad for everyone and rationality will ensure that the rhetoric will after some negotiations settle down and not lead to a full-blown crisis? In reality this can be a dangerous assumption and the worry is that it could go quite far. The reason is that the imbalance is not only true in the trade between the United States and China but with most large partners like Germany, Canada, Japan, Mexico and even the EU as a whole. This means Trump may have more negotiation power because United States has much less to lose negotiating bilaterally while allies have much more to lose collectively.

Which War to focus on

Indeed, these days if a Martian were to land in the USA and open the newspapers they would be surprised to see that every other day the earthlings are fighting a new war over something called trade. One day it seems like there is a fight with neighbors over NAFTA while the next day it is railing over the ungratefulness of the cousins across the seas in Europe. Then you hear of a meeting of the elites called G7 where good friends are meeting to find that the party ended with acrimonious bickering over trade.

The worst rhetoric is being hurled half way around the world, between China and the US. Clearly, the intractable problem seems to be not just the burgeoning trade deficit between the US and China, but the fact that interests between the two economies are diverging in multiple spheres like regional influence, governance structures of multi-lateral agencies (like IMF/World bank), ideological underpinning of rule of law and structures of government and strategically in the long run, control of technology.

The US as the benevolent policeman of global order is rightfully feeling short shifted as it has a deficit against most major economies at the same time as bearing the social and political cost of providing a protective umbrella to enable commerce and relationships to flourish under a rules-based WTO. The academic arguments of comparative advantage vanish when trade gets interlinked with geo-politics. And increasingly it seems like the debate with China is spilling over from trade into hegemonistic concerns about access to markets. For two economies which are so interdependent, the divergence and polar opposite ways of tackling them is a matter of concern. China likes to combine trade with non-tariff barriers and forced technology transfer, while a transactional US president is adding geo-political trade-offs to the basket of trade negotiations.

The recent machinations around the ban on ZTE, a Chinese telecommunication company, found in violation of UN approved sanctions, which was about to face a legal, rules based punitive action, is increasingly becoming a test case of how everything could be up for grabs in the high table of bilateral negotiations to achieve the desired outcome.

This case highlights one of the conundrums of US-China trade negotiations. Rational economist would have believed that US and Europe would have found a common ground and worked together on opening of the Chinese market and reducing the trade deficit which both parties have with China. This is how multi-lateral world used to work. But a transactional administration of President Trump hell bent on achieving the desired outcome promised to its constituents, is ready to bend existing rules, sacrifice precedents and relationships to ensure victory in the shortest possible time. As a dominant economy and large trading partner, the US believes that it holds the negotiating power to get third parties to agree to its viewpoint. Multi-lateral negotiations are long drawn, involve multiple trade-offs with costs and benefits broadly spread out over longer periods of time.

Get ready for a new world

Where we will end up is unclear, but what is obvious over the last year or so is that the world is heading more towards unilateralism away from two decades of multi-lateral consensus. And that is a game for the big players and increasingly the smaller economies will feel the brunt of collateral damage.

In a multi-lateral forum like WTO, even smaller countries have a voice and their concerns get added to melting pot of negotiations, before a consensus is reached and everybody lives with the same set of rules. Medium sized economies which depend on trade like Singapore or Turkey but do not have a place in the table will have to live with a disrupted trade supply chain as the world adjusts to living with a plethora of bilateral trade deals where tariffs between A and B countries are very different from the tariff which country C negotiates with both A and B. This will lead to a world where tariff arbitrage or disruption will be as important as relative comparative advantage. Stronger economies are likely put their interests first to the detriment of global trade.

Maybe, there is still time for pullback to a world which we have got used to, but optimism aside, as the saying goes, “the train has left the station” and now its time for realism to take over and make the best of this new world we are heading into.